Statement by

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before the

United States Senate

Committee on Governmental Affairs

regarding

S. 1527

The Civil Service Pension Reform Act

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Mr. Chairman, my name is Dennis Tito. I am President of Wilshire Associates of Santa Monica, California. Wilshire Associates is a consulting firm that provides guidance and operating systems to over 300 pension funds, profit sharing plans, endowments, money managers, and bank trust departments. In addition, we are members of the New York Stock Exchange and Registered Investment Advisors.

I would like to limit my comments today to the thrift savings plan option provided for in Subchapter III, which is an optional plan permitting participants to contribute a percentage of their basic pay or disability benefits to a selected investment vehicle and have those contributions matched by the government.

We believe that Subchapter III provides an important new avenue whereby Federal employees can enhance their savings for retirement while providing important new sources of investment capital to the public and private markets.

In addition, the thrift savings plan as outlined in Subchapter III appears competitive with plans offered by the private sector, which should help increase Federal employee morale, job satisfaction and retention.

The legislation properly provides Federal employees with three options for the deployment of their assets: a Government Securities Investment Fund, a Fixed Income Investment Fund, and a Common Stock Index Investment Fund. These options will allow individual Federal employees to tailor their investments to their unique goals and objectives, and to adjust their program with changes in age, obligations, and financial security.

We are particularly impressed that the options recognize the need for Federal employees to participate in the productivity and earning capacity of the private sector through the Fixed Income option and, particularly, the Equity Investment option.

Over the past ten years, the owners of all US common stocks have experienced a compounded return of 16.4% per year, far in excess of the inflation rate of 7.4% per year. While we cannot assume that such gains will continue in the future, individuals who participated in Equity investment options in thrift plans over this period have built up substantial assets to help provide adequate retirement income.

The question I wish to address before this Committee is how an Equity option might be best designed for the proposed Federal employees's thrift plan.

I strongly support the recommendation that an index fund represents the best investment management alternative for the equity fund. Index funds represent a low cost, fully diversified means to participate in the earning power and capital appreciation of the private sector. In addition, an index fund is the easiest investment management strategy for non-professionals to understand and observe.

Over the past fifteen years index funds have grown to over $80 billion in assets, approximately four percent of all equity investments. The performance of index funds has been competetive with that of other professional investment managers. Robert Monks, former Administrator of the Office of Pension and Welfare Benefit Programs at the U.S. Department of Labor, cited our studies in a recent Fortune magazine article when he stated that active management strategies have underperformed indexes (and therefore index funds) by up to one percent per year. Because of their low costs of administration, management, and trading, index funds have become an almost standard long-term equity component of large pension and profit sharing funds.

An index fund seems particularly appropriate for a Federal employee option because of its impartiality with respect to individual companies. An index fund holds a proportionate number of the outstanding shares of each company or a random sampling of companies. The Federal government thus can easily avoid any implication of favoritism toward any one company or industry.

My firm, Wilshire Associates, has been active for the last thirteen years in the development and publication of a variety of new stock market indexes, including the widely known Wilshire 5000 index. We currently manage index funds and also lease the software to run index funds to other managers and in-house managed funds. Against this background, I would like to make some specific comments regarding the specific language of Subsection (b) of Section 8427 of the proposed law regarding the design and implementation of the Common Stock Index Investment Fund.

This subsection empowers the Board to define an index which:

> "(i) consists of all the common stocks that are publicly listed and traded on one or more national securities exchanges, or
> (ii) is a commonly recognized index comprised of common stock the aggregate market value of which is at least 50 percent of the aggregate market value of all common stocks that are publicly listed and traded on one or more national securities exchanges."

Point (i) excludes those stocks that are traded over the counter, including many substantial companies that are traded through the NASDAQ system. Many companies such as Apple Computer and MCI Communications have chosen to remain on the NASDAQ system long after they meet the qualifications to be listed on an exchange. We believe the intent of the proposed law here is to assure market liquidity and open, fair market pricing. Such objectives can be met without requiring formal exchange listing.

In total, there are more than 3000 unlisted yet actively traded companies valued at $180 billion which represent nine percent of the aggregate value of all companies. More importantly, these companies differ in substantive ways from the listed companies. As John Naisbitt suggested in Megatrends, the US economy is increasingly oriented toward smaller, less capital intensive and more entreprenurial companies. Often these emerging companies do not qualify for exchange listing, yet they may represent "the economy of the future" and better investment prospects.

It should be recognized that these companies are inherently riskier than larger, more established companies. The index fund, however, compensates for individual company risk by diversifying over hundreds, even thousands of companies.

Point (ii) suggests that a commonly recognized index could be adopted as the index fund tracking standard. The most commonly recognized index, the Dow Jones 30 Industrials, is totally inappropriate: it contains only thirty stocks and is weighted according to stock price rather than company size.

Most index funds index to the Standard and Poor's 500 Stock Composite Index. There are several reasons to suggest that the S&P 500 index may not be the most appropriate base for the Common Stock Index Investment Fund:

1) Five hundred companies -- a leftover from pre-computer days -- is less than ten percent of the number of companies that trade regularly.

2) The companies selected for the S&P 500 are often the oldest, largest companies in their industry. Newer, faster growing companies and companies in new industries often have to wait for an opening before there is room for them in the arbitrarily limited total of 500 companies.

3) The industry dispersion of the S&P 500 does not agree with that of more broadly based indexes. There is a bias toward mature, capital intensive, industrial giants. For example, oil companies represent 14.6% of the S&P 500 but only 9.3% of the entire US market.

4) As suggested above, the smaller companies and industries that Naisbitt wrote about are underrepresented in the "smokestack" nature of the S&P 500.

5) New companies are brought into the S&P 500 by the S$P 500 committee at Standard and Poors. The deletion and insertion of a single company revises the weightings of all other stocks in the index.

6) No adjustment is made for intra corporate holdings. During 1984 Shell Oil was carried in the S&P 500 at full weight, even though 99% of the shares were held at that time by Royal Dutch Petroleum, a foreign company.

7) Most importantly, the proportion of the US economy represented by the S&P 500 has declined from over 80% in 1973 to less than 68% today. As the Megatrends economy continues, it will become more and more difficult to represent the entire US economy with only 500 stocks.

These problems are not a reflection on the S&P 500 as much as they are indicative of the problems faced using any index that comprises less than the totality of the US market.

Subsection (b)(2)(B) of the proposed law mandates that each stock found in the index must be held in the index fund. This is neither practical nor desirable if the number of securities in the index is increased. Fortunately, there are widely used sampling techniques that allow index replecation without holding each and every issue. The critical difference is between precise tracking of an inaccurate barometer of the US stock markets, versus an accurate tracking of a more representative measure.

In conclusion, we would suggest the following changes to the proposed legislation:

With respect to Subsection (b)(2)(A)(i), provision should be ammended to incorporate NASDAQ listed over the counter stocks;

With respect to Subsection (b)(2)(A)(ii), provision should also be ammended to incorporate NASDAQ listed over the counter stocks, and the proportion of stocks represented in the index should be increased from 50% to "as complete a representation of the US equity markets as reasonably practicable;" and

With respect to Subsection (b)(2)(B), to alter the language to allow the Board to permit sampling of stocks in the construction of the index fund.

Mr. Chairman and members of the Committee, I am honored to have the opportunity to express my views on this proposed legislation. If you have any questions, or would like my views on other issues, I am open to questions.